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Mr Kevin Stevenson
 Chairman
 Australian Accounting Standard Board
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Dear Mr Stevenson 

ED 242 Leases

The Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) welcomes the opportunity to respond to the Australian Accounting Standards Board's Exposure Draft (ED) 242 *Leases*.

HoTARAC acknowledges that the existing lease accounting model is problematic and therefore supports the objectives of this project. HoTARAC supports:

- adopting a standard that applies to both lessees and lessors;
- recognising assets and liabilities arising from non-cancellable lease contracts;
- the dual approach to lease accounting depending on the degree to which the lessee consumes the economic benefits embedded in the underlying asset;
- the lease term being determined as the non-cancellable period of the lease; and
- adopting simplified requirements for short-term leases.

HoTARAC considers that the 2013 ED improves on the Board's 2009 Discussion Paper and 2010 Exposure Draft and notes that it addresses many of the issues raised by HoTARAC in response to those proposals. However, HoTARAC has some additional concerns with the 2013 ED. These are set out in the Attachments and primarily relate to:

- relief given to lessors in short-term leases [Question 3];
- inconsistent terminology in relation to lease classification [Question 4];
- lease classification where a lessee measures its right-of-use asset based on fair value [Question 4];
- guidance on determining the lease term [Question 5];

- recognising, measuring and presenting variable lease payments [Question 6];
- revaluation of a lessor's residual asset [Question 6];
- excessive disclosures [Question 8]; and
- GAAP/GFS harmonisation issues [AASB specific Question 1].

HoTARAC recommends that the Board allows a **substantial** period for implementation in view of the likely impact of the proposal on accounting systems and processes.

Please contact David Laidley on 02 9228 4759 from New South Wales Treasury if you would like to discuss any of the matters raised by HoTARAC.

Yours sincerely



Grant Hehir

CHAIR

HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

14th

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DETAILED COMMENTS ON EXPOSURE DRAFT ED 242 LEASES

HoTARAC offers the following comments and suggestions in response to the questions in the exposure draft (ED) and related matters.

Scope

Question 1 Identifying a lease

The revised Exposure Draft defines a lease as “a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.” An entity would determine whether a contract contains a lease by assessing whether:

- (a) fulfilment of the contract depends on the use of an identified asset; and
- (b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from the use of the identified asset.

Do you agree with the definition of a lease and the proposed requirements in paragraphs 6-19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

HoTARAC agrees with the definition of lease and the proposed requirements in paragraphs 6-19 for how an entity would determine whether a contract contains a lease.

HoTARAC considers the proposal to be an improvement on IFRIC and AASB Interpretation 4 *Determining whether an Arrangement contains a Lease* and particularly the guidance on the right to control the use of the asset in paragraph 9(c) of that Interpretation.

HoTARAC would welcome additional guidance on interpreting and applying the definition of a lease, particularly in relation to barriers to substituting alternative assets [paragraph 9(b)] and ability to derive benefits from use [paragraphs 12(b), 18 and 19].

The accounting model

Question 2 Lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and cash flows from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

HoTARAC agrees that a lessee's accounting should vary, depending on the degree to which the lessee consumes the economic benefits embedded in the underlying asset.

While this approach does not always result in symmetrical accounting by lessees and lessors (especially in Type B leases), it appears to be a reasonable and principles-based approach that recognises the variable nature of the underlying economics of leases. It also acknowledges that leases are not always financing arrangements.

Question 3 Lessor accounting

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

HoTARAC agrees that a lessor's accounting should vary, depending on the degree to which the lessee consumes the economic benefits embedded in the underlying asset.

While this approach does not always result in symmetrical accounting by lessees and lessors (especially in Type B leases), it appears to be a reasonable and principles-based approach that recognises the variable nature of the underlying economics of leases. It also acknowledges that leases are not always financing arrangements.

HoTARAC notes that, in a Type B lease, the lessor continues to recognise the leased asset while the lessee recognises a right-of-use asset in relation to the same asset. The recognition of an asset by both parties, conceptually, is not ideal.

Optional relief for lessors in short-term leases

HoTARAC notes that while lessors in short-term leases are given optional relief from the measurement requirements that would otherwise apply, they are not given relief from the recognition requirements.

Paragraph 119 gives a lessor, in a short-term lease, optional relief from the requirements of paragraphs 69-97. Those paragraphs relate to measurement. The optional relief does not extend to the recognition requirements in paragraph 68. This does not appear to be the intention of the proposals as set out in the *What are the main proposals?* section on page 7 of the ED which states that the simplified requirements (for short-term leases) would be similar to operating lease accounting.

HoTARAC recommends that a lessor in a short-term lease also be given optional relief from the recognition requirements in paragraph 68.

HoTARAC also recommends that the proposed relief be mandated for all short term leases. This will enhance comparability between entities, as similar transactions will be accounted for consistently.

Question 4 Classification of leases

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28-34, which differ depending on whether an underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

HoTARAC agrees that lease accounting should vary depending on the degree to which the lessee is expected to consume the economic benefits embedded in the underlying asset. HoTARAC also agrees that in many leases this principle can be conveniently operationalised by distinguishing equipment leases from property leases, subject to the appropriate exception criteria in paragraphs 29 and 30, and accounting for them differently.

HoTARAC notes the inconsistent terminology used in the exception criteria for distinguishing Type A leases from Type B leases. Type A exceptions are based on *insignificant* economic life and fair value of the underlying asset whereas Type B exceptions are based on the *major part* of the economic life and *substantially all* of the fair value of the underlying asset. HoTARAC recommends using more consistent terminology, defining what is meant by *insignificant*, and either replacing *major part* and *substantially all* with *significant* or defining those terms.

Lease classification where the lessee measures the right-of-use asset based on fair value

HoTARAC notes that where a lessee measures the right-of-use asset at, or based on, fair value, as permitted by paragraphs 52 or 53 of the proposal, paragraph 35 prohibits the lease from being classified as a Type A lease or a Type B lease. While paragraph 35 requires such a lease to be treated as a Type A lease for presentation and disclosure purposes, it is unclear how it should be classified and therefore recognised in this situation. Public sector entities in Australia would be likely to measure their right-of-use assets based on fair value, as they presently do with property plant and equipment.

HoTARAC therefore recommends that the proposal clarify how a lease should be classified and recognised if the lessee chooses to measure the right-of-use asset based on its fair value.

Asymmetry in Type B leases

HoTARAC notes that lessee and lessor accounting is symmetrical in a Type A (equipment) lease but asymmetrical in a Type B (property) lease. In the latter, the lessee recognises a lease liability but the lessor does not appear to be required to recognise a corresponding lease receivable. This appears to be inconsistent with the core principle of the proposal: that an entity shall recognise assets and liabilities arising from a lease [paragraph 1]. Is this the boards' intention? Where the lessee and lessor are both entities within the same group, as is often the case in the public sector, this asymmetry will have to be adjusted in the consolidated whole-of-government financial statements.

Peppercorn leases

HoTARAC notes that where a lease has peppercorn lease payments, the usual lease classification may be reversed. An equipment lease would be classified as a Type B lease *because* “the present value of the lease payments would be insignificant relative to the fair value of the underlying asset at the commencement date”. A property lease for the major part of the remaining economic life of a building would be classified as a Type A lease, *despite* “the present value of the lease payments being insignificant relative to the fair value of the underlying asset at the commencement date”. This is not necessarily an issue but entities with peppercorn leases would need to be careful of how they classify them.

HoTARAC recommends that the AASB provide extra guidance on this for not-for-profit entities.

Measurement

Question 5 Lease term

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

HoTARAC agrees with the proposals and considers them to be much more workable than those in the 2010 exposure draft.

HoTARAC notes that the lease term includes periods covered by an option to extend (or early-terminate) the lease where the lessee has a significant economic incentive to exercise (or refrain from exercising) the option. Despite the guidance given in paragraph B5, HoTARAC considers the meaning of *significant economic incentive* to be open to interpretation and requests further guidance of the meaning of *significant* in this context.

HoTARAC also requests further guidance on when a change to the lease term or variable payments would be recognisable. For example, would in-principle agreement between the parties be sufficient or would a formal change of the contract be necessary?

Question 6 Variable lease payments

Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

HoTARAC disagrees with several aspects of the proposals on the measurement of variable lease payments.

In HoTARAC’s view, the requirements in paragraphs 39(c) and 70(c) for a lessee’s lease liability and a lessor’s lease receivable, respectively, to include ‘variable lease

payments that are in substance fixed payments' is too subjective and would be open to manipulation. If the Boards proceed with including such payments in the lessee's lease liability and the lessor's lease receivable, HoTARAC strongly recommends that further guidance be included.

HoTARAC also recommends that variable lease payments dependent on an index or rate initially measured at the rate at the commencement of the lease term only be reassessed where there is a significant change in lease terms.

HoTARAC suggests that variable lease payments in very long-term leases be measured in the same way as other long term assets or liabilities, for example using a superannuation liability approach.

HoTARAC disagrees with the proposal, in paragraph 72, for certain variable lease payments receivable by a lessor to be included in the initial measurement of the residual asset. HoTARAC considers that such payments should instead be accounted for as part of the lessor's lease receivable.

HoTARAC also finds paragraph 72 to be unclear and requests the Boards to provide some clarification in the final standard.

HoTARAC notes that there is no guidance on how a lessee (or lessor) should present variable lease payments *not* included in the lease liability (or the lease receivable). Should they be presented separately or included in the lessee's interest expense (or lessor's interest income)? HoTARAC recommends that such payments be presented separately and suggests that this be clarified in the final standard.

Revaluation of the residual asset

As explained in paragraph BC261, a lessor in a type A lease is not permitted to revalue the residual asset.

HoTARAC is concerned that the restriction on the revaluation of residual assets will cause inconsistencies for entities, such as Australian public sector entities, that adopt the revaluation model for similar property, plant and equipment.

HoTARAC therefore requests the Board to reconsider its reasoning and recommends that a lessor be permitted to apply the revaluation model to a residual asset if it applies that model to similar items of property plant and equipment.

Transition

Question 7 Transition

Paragraphs C2-C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

Are there any additional transition issues the boards should consider? If yes, what are they and why?

HoTARAC agrees with the proposal to permit two approaches to transition.

HoTARAC considers that the full retrospective approach is conceptually superior to the modified retrospective approach. Given the long-term nature of some leases, differences between the full and modified approaches could produce long-term comparability issues between entities. However, the full retrospective approach would add to the complexity of initial implementation, probably with little real benefit for users of financial statements.

Therefore, HoTARAC acknowledges the practicality of the modified retrospective approach and considers that allowing a choice of approaches is a reasonable and pragmatic solution.

HoTARAC expects the proposals to be challenging and costly to implement, regardless of whether the full or modified retrospective approach is adopted. HoTARAC therefore recommends that the Boards allow entities a *substantial* period to adopt the proposals.

Disclosure

Question 8 Disclosure

Paragraphs 58-67 and 98-109 set out the disclosure requirements for a lessee and lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

HoTARAC strongly supports the disclosure objectives set out in paragraphs 59 and 98 but disagrees with the voluminous mandatory disclosures listed subsequently. These requirements are too prescriptive and rules-based.

HoTARAC notes that the proposed disclosures are more extensive than those of the existing standard and considers that they would be excessive for some entities and would potentially confuse users.

Therefore, HoTARAC urges the Boards to review the need for so many disclosures. HoTARAC suggests that most of the disclosure paragraphs could be framed as examples of information that would meet the disclosure objective, subject to relevance and materiality considerations.

In particular—

- Paragraphs 54, 89 and 90 give preparers discretion as to whether to present lease disclosures on the face of the financial statements or in the notes. HoTARAC recommends removing such choice as it may result in inconsistent reporting and could facilitate financial statement manipulation. It is also likely to impair comparability between entities and potentially between years.
- Paragraphs 58 and 98 require disclosure of qualitative and quantitative information about *all* leases. HoTARAC suggests that the proposal should be clarified regarding the level of detail to be disclosed. For example, would these paragraphs require an entity to disclose the vehicle registration number for each leased vehicle?
- Paragraphs 61, 64, 103 and 104 require lessees and lessors to disclose reconciliations of amounts recognised in the statement of financial position. HoTARAC recommends removing these requirements. This information is likely to be confirmed during the audit.

Questions 9, 10 and 11

HoTARAC has no comments on Questions 9, 10 and 11 as those questions relate only to the proposed FASB standard and therefore would not apply in Australia.

Other comments

Consequential amendments to the framework

Appendix D to the exposure draft sets out amendments to other standards.

HoTARAC notes that the AASB's Framework for the Preparation and Presentation of Financial Statements will also need to be amended. It refers to finance leases at paragraph 51 and leases at paragraph 57.

Editorial suggestions

Appendix A contains a definition for *investment property* which paraphrases the full definition set out in IAS 40 *Investment Property*. HoTARAC considers that it would be more appropriate to refer readers to the original standard rather than paraphrasing the definition.

HoTARAC suggests the following editorial improvements to remove potential ambiguity.

- In paragraph 41(b), replace *unless paragraph 52 or paragraph 53 applies* with *subject to paragraphs 52 and 53*; and
- In paragraph 54(c), clarify whether it is two or three types of right-of-use assets that are to be presented separately.

ADDITIONAL COMMENTS ON AASB SPECIFIC MATTERS

Question 1 GAAP/GFS harmonisation

In relation to AASB 1049 *Whole of Government and General Government Sector Financial Reporting*:

- (a) are you aware of any implications for GAAP/GFS harmonisation of the proposed changes?
- (b) how do you think the implications for GAAP/GFS harmonisation of the proposed changes should be dealt with in the context of the principles in AASB 1049?

HoTARAC notes that GFS currently distinguishes operating leases from finance leases. The proposals will fundamentally change the basis for lease classification and change the recognition and measurement requirements for lessees and some lessors. These changes are likely to increase GAAP/GFS divergence.

HoTARAC notes that the proposals introduce asymmetry between lessor and lessee accounting in Type B leases. Conceptually this will be incompatible with GFS and will create a GAAP/GFS harmonisation issue.

The implications of using different lease classification schemes for GAAP and GFS are unclear. However, HoTARAC considers that several possible issues are likely to arise—

- New GAAP/GFS convergence differences would arise in relation to other economic flows (as defined in AASB 1049) as lessees would recognise reassessments of right-of-use assets and lease liabilities and revaluations of right-of-use assets under GAAP but not under GFS.
- The value of various key fiscal aggregates (as defined in AASB 1049) would change, for example net lending/(borrowing) would increase due to more leases being recognised on balance sheet.
- Net debt and net financial liabilities would increase due to the more extensive recognition of lease liabilities under the proposals. This could adversely affect a government's credit ratings.

HoTARAC also observes that GFS uses the term *amortisation* in relation to non-produced assets (eg land, subsoil assets and certain intangible assets) whereas the ED uses it in relation to right-of-use assets (paragraphs 41 and 42). It is unclear whether a right-of-use asset would ever be recognised under GFS and, if it was, whether it would be regarded as non-produced and therefore subject to amortisation under GFS.

Question 2 Regulatory issues

Are there any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

- (a) not-for-profit entities; and
- (b) public sector entities?

HoTARAC is not aware of any regulatory issues that may affect implementation of the proposals.

Question 3 Usefulness to users

Overall, would the proposals result in financial statements that would be useful to users?

HoTARAC considers that the proposals would result in financial statements that are more useful to users, principally because of the recognition of lessees' right-of-use assets and lease liabilities.

Question 4 The Australian economy

Are the proposals in the best interests of the Australian economy?

HoTARAC makes no comment on whether the proposals are in the best interests of the Australian economy.

Question 5 Costs and benefits

Do you have any comments on the costs and benefits of the proposals relative to current requirements, whether quantitative (financial or non-financial) or qualitative?

HoTARAC notes the comprehensive effects analysis in paragraphs BC329 to BC439 and has nothing further to add.